IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1138

LE BEAU TOURS INTER-AMERICA, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner Le Beau Tours Inter-America, Inc. respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on November 23, 1976.

Opinions Below

The opinion of the Court of Appeals (A 1-4)* is not yet officially reported, but appears at 39 AFTR 2d ¶ 77-309,

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* Numbers in parentheses prefixed by the letter "A" refer to pages of the Appendix to this petition. Numbers in parentheses prefixed by the letter "R" refer to numbered documents contained in the Record in the Court of Appeals. The Clerk of the Court of Appeals has been requested to transmit a certified copy of the record to this Court pursuant to Rule 21(1) of the Supreme Court Rules.

p. 77-355. The opinions of the District Court (A 5-13) for the Southern District of New York (main opinion of 3/10/76 and supplemental opinion of 5/18/76) both are officially reported at 415 F. Supp. 48 (S.D.N.Y. 1976).

Jurisdiction

The judgment of the Court of Appeals was entered on November 23, 1976. A timely petition for rehearing containing a suggestion that the action be reheard en banc was denied on January 3, 1977.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) and Rule 19(1)(b) of the Supreme Court Rules.

Questions Presented

1. Does the source of income concept of the Internal Revenue Code (I. R. C.) relate to the places where activities occur which help generate the income, or does it relate to the place where the ultimate act occurs for which the income is earned?

2. Is the income which a U.S. taxpayer earns as compensation for purchasing goods or services abroad for U.S. customers, derived from sources without the U.S.?

3. Should the Supreme Court exercise its power of supervision in cases where the Court of Appeals disregards without explanation decisions in other Circuits and other precedents cited by counsel to the Court which conflict with the conclusion of the Court of Appeals?

Statutes Involved

The statutes involved are sections 921 and 922 of the Internal Revenue Code of 1954 as amended (26 U.S.C. § 921, 922), and are set out verabtim at A 14-15.

Statement

The facts as stipulated to by the parties (R17), and as set forth in the District Court Opinion (A 5-13) are as follows:

Taxpayer appellant is a travel merchant which assembles abroad package tours for American tourists and sells the tours in the U.S. Taxpayer was organized as a Western Hemisphere Trade Corporation ("WHTC") in order to take advantage of the tax incentive offered by Congress in § 921/922 I.R.C. Taxpayer's corporate headquarters were in New York City, in the office of its domestic affiliate, Le Beau Tours, Inc. The domestic affiliate and its officers rendered administrative and promotional services to taxpayer for which taxpayer compensated the domestic affiliate.

The services which taxpayer provided in the package tours consisted of the supply of hotel space and the facilities by so-called ground operators. The latter furnished transportation by bus or taxi, as well as escort services abroad. Moreover, taxpayer supplied travel assistance abroad through offices maintained in foreign countries in the Western Hemisphere.

Taxpayer's profit consisted of commissions which the foreign hotels and ground operators paid to taxpayer. Taxpayer withheld these commissions from the gross amounts collected by it from American tourists for the foreign accommodations.

In auditing the tax returns for 1966, 1967 and 1968 the IRS disallowed the Special Deduction allowed for a WHTC under § 922 I.R.C. on the ground that taxpayer did not qualify as a WHTC because less than 95% of its income was derived from sources without the U.S. as required by § 921(1) I.R.C.

After exhausting its administrative remedies, taxpayer sued in the District Court for the Southern District of New

York for a refund of $101,689.65 plus interest. The jurisdiction of the District Court was invoked under 28 U.S.C. § 1346(a)(1). All relevant facts were stipulated. The District Court granted summary judgment for the Government and dismissed the complaint. The Court of Appeals affirmed, and denied a rehearing. It also denied a suggestion for an en banc hearing, which taxpayer had made because the affirmance by the Court of Appeals was at variance with a prior decision of the Court by a different panel and was at variance with all known decisions in other Circuits.

Ruling Below

The Court of Appeals held: The source of the income of a New York travel merchant corporation (organized as a WHTC) which consists of commissions paid to it by foreign hotels and ground operators is determined by an apportionment of the time spent by the corporation on its foreign activities and the time spent at the corporation's headquarters.

Reasons for Granting the Writ

I. The decision of the Court of Appeals is in conflict with all relevant decisions in other Circuits and its own prior holding, the U.S. Court of Claims and pertinent Revenue Rulings.

II. The importance of the "source of income" concept (misconceived in the opinion below) transcends the present case; it remains relevant to the proper application of numerous sections of I.R.C.

III. The Court of Appeals failed to consider and ignored the relevant points of law raised in the appeal. This failure calls for the exercise of the Supreme Court's supervisory power, in the interest of the efficient and economic administration of justice.

I. The decision of the Court of Appeals is in conflict with all relevant decisions of other Circuits and its own prior holding and the Court of Claims and pertinent Revenue Rulings.

(1) Sec. 921 I.R.C. requires that 90% of the taxpayer's income must be derived from the active conduct of business in the Western Hemisphere including the United States. Sec. 921 I.R.C. also requires that 95% of the income of a WHTC must be derived from sources without the United States. The converse of this is that not more than 5% of the income be derived from sources within the United States. Taxpayer conceded by stipulation that more than 5% of its time was spent in the U.S. On this basis, the District Court held that taxpayer did not meet the 95% source of income test, and the Court of Appeals affirmed on that same ground. The Courts below ruled that (i) taxpayer's income was both from sources within and without the U.S., (ii) that taxpayer's income must be apportioned according to the time spent on taxpayer's business, and (iii) that, accordingly, more than 5% of taxpayer's income was derived from sources within the U.S., thus depriving taxpayer of the tax benefit of a WHTC.

The District Court and the Court of Appeals failed to recognize that "time spent" by taxpayer relates to the 90% activity test of Sec. 921(2) I.R.C. and not the 95% source of income test of Sec. 921(1) I.R.C.

Taxpayer readily conceded that more than 5% of its time and work expenditure took place in New York because it took into consideration the activity of its domestic affiliate at the New York headquarters. The Court of Appeals overlooked that even heavy activity at domestic headquarters does not preclude the WHTC benefits, and that its contrary decision is in conflict with established law as promulgated by the Fifth, Seventh and Ninth Circuits, and an earlier panel of the Second Circuit, as well as other decisions.

In *Frank* v. *International Canadian Corp.*, 308 F.2d 520 (1962) the Court of Appeals for the Ninth Circuit dealt with a case where the domestic affiliate of the WHTC performed all administrative work of the Western Hemisphere business at the common corporate headquarters at Seattle. The WHTC had no personnel other than the personnel of the domestic affiliate, and the WHTC had simply taken over the Western Hemisphere Trading business previously conducted by the domestic affiliate. The Court of Appeals for the Ninth Circuit ruled that the activities of the domestic affiliate did not preclude the WHTC from the benefit of § 921 I.R.C.

In *Commissioner* v. *Hammond Organ Western Export Corp.*, 327 F.2d 964 (1964) the Circuit Court of Appeals for the Seventh Circuit dealt with a similar situation. Again the Court held that the activities of the domestic affiliate on behalf of the WHTC at the common corporate headquarters are to be disregarded in the determination of whether or not a corporation qualifies as a WHTC under § 921 I.R.C. In its opinion, the Court of Appeals for the Seventh Circuit pointed out that if Congress had wished to remedy the recurrent complaints of the Commissioner of Internal Revenue about the alleged misuse of WHTC benefits, it had an opportunity to do so in the Revenue Act of 1962, but Congress deliberately took no exception to the prevailing rule. In *Baldwin-Lima-Hamilton* v. *U.S.*, 435 F.2d 182 (1970) the Circuit Court of Appeals for the Seventh Circuit did not even discuss the problem and obviously took it for granted that the WHTC benefit is not precluded merely because "most of the work" is done at domestic headquarters by a domestic affiliate. The prevailing rule was also applied by the Court of Appeals for the Second Circuit in its earlier decision in *Commissioner* v. *Pfaudler Inter-American Corp.*, 330 F.2d 471 (1964), decided by a panel of three judges who are now senior judges of the Court and who took no part in the present decision.

In *Comm.* v. *Pfaudler, supra,* the Court of Appeals for the Second Circuit concluded that it saw no reason to depart from established precedents (which the Court cited) —but the instant decision disregards all such precedents without stating a reason for the departure from the precedents.

It should be mentioned that the government's argument in these earlier cases was not so much addressed to the concept of source of income as to the general proposition that the taxpayer's use of the WHTC was a tax dodge which should not be regarded as active conduct of business. However, as is especially apparent from the opinion of the Court of Appeals for the Ninth Circuit in *Frank* v. *International Canadian Corp.*, 308 F.2d 520 (1962) the government's rejected argument was virtually the same as the government's contention in the instant case, which was upheld below.

(2) Specifically, in respect to the "source of income" concept the present decision is also in conflict with two decisions of the Court of Appeals for the Fifth Circuit which the present panel of the Court of Appeals completely ignored.

Comm. v. *East Coast Oil Co.*, 85 F.2d 322 (1936) involved the sale of Mexican Oil to purchasers in the United States. The sales were negotiated and payment was made in the U.S. Delivery was made in Mexico. The Commissioner contended that the vendor's income was from "sources within the U.S." The Court held to the contrary that the income was "from sources without the United States." The Court said it was immaterial who paid the price and when it was paid. What matters for the determination of the source of income is the place where the profit was earned, and that was the place where the oil was delivered.

In the instant case, taxpayer's profit was earned when the American tourist occupied the foreign hotel space and made use of the facilities of the foreign ground operators.

The second decision of the Court of Appeals for the Fifth Circuit which is in conflict with the present decision is *Commissioner* v. *Piedras Negras Broadcasting Co.*, 127 F.2d 260 (1942). That case like the instant case involved the rendering of services. Prior to the present decision, *Piedras Negras* was the leading authority for the "source of income" concept, but the instant decision completely ignores this precedent.

In that case two Americans organized a Mexican corporation and established a broadcasting station in Piedras Negras, across the Rio Grande River. The main business of the Mexican broadcasting station was to sell radio time to American advertisers of American goods. Advertisers were solicited through agents in the United States. The American advertisers paid the Mexican corporation generally on a percentage of sales basis, and payment was made at Eagle Pass, Texas. The Commissioner asserted that these payments were taxable as income from sources within the United States because they came from the American advertisers. The Court ruled to the contrary, confirming the Board of Tax Appeals in its holding that the income was from sources without the United States, from where the broadcasting service emanated. Said the Court: "the source of the income is the situs of the income producing services". Solicitation of customers was not regarded as income producing service. In the instant case, like in *Piedras Negras:*

1) solicitation of customers took place within the U.S.;

2) the paying customers were located in the U.S.;

3) the source of gross income was the supply of services without the U.S. In *Piedras Negras*, these services consisted of sending radio programs. In the present case the services consisted of arranging abroad for a packaged combination of hotel accommodations,

ground transportation, escort services and assistance offices.

(3) The Court of Appeals, in the instant decision, recognized that taxpayer is a purchasing agent for American tourists. For some reason, which we do not understand, the Court denigrates this purchasing activity. The opinion below says that taxpayer "merely purchases [the services] from foreign 'ground operators' [meaning hotels and ground operators] for its American clients."

It seems clear that taxpayer is correctly denominated as a purchasing agent. It is established law that a purchasing agent earns his commission in the place where the purchase takes place. This was affirmed in *Rev. Rul.* 56-477. As the purchases in the instant case take place in Central and South America, there should be no question that the income of taxpayer must be regarded as income from sources without the United States.

The same principle was recognized by the Treasury Department in *Rev. Rul.* 63-269. In that case, a domestic airline received a government subsidy for flying its planes over a route lying entirely outside the United States. The Treasury ruled that the subsidy constituted income from sources without the United States, because it was earned abroad for services performed abroad. (The name of the airline is not disclosed, but since it was a domestic airline it is fair to assume that the flights abroad were directed from corporate headquarters in the U.S., which obviously is irrelevant to the source of income test.)

(4) Except for the last two mentioned Revenue Rulings and the *Piedras Negras* decision, *supra*, the cited precedents involve merchandise transactions rather than taxpayers who, like the instant taxpayer, render services. Possibly the Courts below attached weight to this distinction, however, any such distinction is entirely illogical and without foundation in the statute or the case law. What

counts in each of the cases is where the income was earned, i.e., the situs of the activities which triggered the income. See *Rev. Rul.* 76-154.

Former WHTC decisions struggled at length with the question whether the place of the transfer of title to merchandise determined the source of income. This was a problem because of the vacillating attitude of the Commissioner of Internal Revenue (See A. P. David, 10 Harvard Int'l L.J. 101 (Winter 1969)). However, the crucial test for the source of income always was and still is: where is the income earned. *Comm.* v. *East Coast Oil Co., supra, Comm.* v. *Piedras Negras, supra, Rev. Rul.* 56-477, *Comm.* v. *Pfaudler, supra.*

II. The importance of the source of income test transcends the instant case; it remains relevant to the proper application of numerous sections of the I.R.C.

The important Tax Law concept of source of income is of a technical and sophisticated nature, which the decisions below seem to have disregarded for which reason the attention of the Supreme Court is called for. The complex nature of the concept is illustrated by two U. S. Tax Court decisions which held that income from a foreign bank account may be income from sources within the U. S. (*Howkins*, 49 T.C. 689 (1968) and *Lamm*, T. C. Memo 1975-95). Similarly, interest on U.S. bank deposits paid to nonresidents is treated as income from sources without the U.S. (Sec. 861(a)(1)(A) I.R.C.)

Sec. 861 seq. I. R. C. contain technical rules concerning the source of income concept, and the courts below have erroneously cited Treas. Reg. § 1.861-4 (b) (2) in support of the conclusion that the taxpayer's income should be allocated partly to sources within and partly to sources without the U.S. The technical rules of Sec. 861 seq. I. R. C. and the predecessor statutes were enacted to limit the tax

liability of nonresident aliens. They do not apply to the entire body of tax law, as was pointed out by *Rev. Ruling* 70-304, and lately again in *Rev. Rul.* 76-154, and they are not applicable in the instant case. However, assuming without conceding that the technical rules of Sec. 861 seq. apply to the instant case, the Courts below have overlooked that their method of allocation is authorized only by Sec. 863 I. R. C., which expressly forbids allocation in cases covered by either Sec. 861 or Sec. 862 I. R. C. The instant case is covered by Sec. 862 (a) (3) which states that compensation for services performed without the United States is income from *sources without* the U.S. Sec. 861 (a) (3) deals with compensation for services performed within the U.S. but, even assuming again without conceding, that some of taxpayer's income was compensation for services performed within the U.S., such compensation is not considered as income from sources within the U.S. but from *sources without*, because the compensation was paid under contract with the foreign hotels and ground operators. (Sec. 861 (a) (3) (C) I.R.C.). The foregoing seems clear from a reading of the I.R.C. The Court of Appeals has disregarded this matter of statutory construction.

Under the Tax Reform Act of 1976 (Sec. 1052 (b), (d)) the Western Hemisphere Trading Corporation is to be phased out.

This does not diminish the need for an unequivocal determination of what "source of income" means in the law of taxation and for a correction of the instant decision of the Court of Appeals. The concept of source of income remains important, not only in connection with the technical rules of Sec. 861 seq. I. R. C. but also in connection with numerous other aspects of the tax law.

The most important of these is the provision for foreign tax credit—Sec. 901 seq. I. R. C. To illustrate: In the instant case, the question of foreign tax credit would arise if a foreign country where appellant taxpayer oper-

ates and earns income should levy an income tax. (The Record does not indicate that in the instant case any such tax was levied in 1966, 1967 or 1968, the years under review). Taxpayer is only entitled to foreign tax credit for a tax on income from foreign sources (Sec. 904 I. R. C.). Therefore, if, as the Court of Appeals has ruled in the instant case, taxpayer's income is not from sources without the United States, taxpayer would not be entitled to the credit for foreign taxes, an obviously bizarre result.

Another important application of the source of income concept is the rule which requires that nonresidents not engaged in business must pay a flat 30% income tax on fixed and determinable income from sources within the United States (Sec. 871 & 881, 882 I. R. C.) and no income tax if such income is derived from sources without the United States. To illustrate: If the New York nominee of a British taxpayer receives dividend income, the income is subject to the 30% tax if the dividend comes from a U.S. corporation (source within the U.S.) and no tax if the dividend comes from a Canadian corporation (source without the U.S.).

Other examples of the importance of the source of income concept are found in the following sections of the Internal Revenue Code: Sec. 911 (Earned income from sources without the United States), Sec. 931 seq. (Income from possessions), Sec. 933 (Residents of Puerto Rico), Sec. 934 (Virgin Islands), Sec. 935 (Guam), Sec. 941 seq. (China Trade Act Corp.).

The definition of Subpart F income of a Controlled Foreign Corporation excludes income from sources within the United States (Sec. 952 (b) I. R. C.). Furthermore, the percentage of income derived from sources without the United States is important in the definition of the Export Trade Corporation (Sec. 971 (a) I. R. C.).

Rev. Rul. 76-154 offers another illustration of the general importance of the source of income concept.

III. The interest of efficient and economic administration of justice requires the Supreme Court to exercise its power of supervision.

Although the issues raised in this petition were submitted to the Court of Appeals, they are not dealt with in the opinion below.

When Congress in 1891 created the Circuit Courts of Appeals, the purpose was to have these intermediate appeals courts clarify as many issues as possible in order to lighten the burden of the Supreme Court. Obviously, this need is greater than ever but the Court of Appeals has disregarded this need. It has failed to deal with the issues presented, has failed to take notice of existing judicial precedents in other Circuits and of three of its own Senior Judges, has ignored the doctrines promulgated by decisions of the U.S. Court of Claims and by Revenue Rulings, has rendered a decision without either distinguishing or reconciling such decision and the prior contrary decisions, or even expressly overruling such contrary decisions and has failed to explain its cursory construction of Sec. 861 seq. I.R.C.

We respectfully submit that the Supreme Court through exercise of its supervisory power pursuant to Rule 19 (1) (b) of the Supreme Court Rules should express its disapproval of the described inadequate manner of dealing with serious legal issues. The Court of Appeals for the Second Circuit properly demands that counsel present a well-briefed argument. This has been done in the instant case. However, the administration of justice is ill-served if, as in this case, the Court of Appeals affirms a District Court decision without giving any attention to the issues presented on appeal, and in its opinion even fails to state why the grounds for appeal and the cited precedents are ignored. The result is confusion rather than clarification.

CONCLUSION

On the uncontroverted facts, the judgment of the Court of Appeals should be reversed and petitioner should be granted summary judgment.

Respectfully submitted,

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Opinion of the Court of Appeals.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 246—September Term, 1976.

(Argued November 11, 1976 Decided November 23, 1976.)

Docket No. 76-6093

LE BEAU TOURS INTER-AMERICA, INC.,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Before:

KAUFMAN, *Chief Judge,*
SMITH and TIMBERS, *Circuit Judges.*

Appeal from an order of the United States District Court for the Southern District of New York, Lee P. Gagliardi, *Judge,* granting summary judgment to the United States of America, from whom Le Beau sought a tax refund for 1966, 1967, and 1968, based on the disallowance of its special deduction as a "Western Hemisphere trade corporation". Affirmed.

FRANK G. OPTON (Lynton, Klein, Opton & Saslow, New York, New York, on the brief), *for Plaintiff-Appellant.*

WILLIAM G. BALLAINE, Assistant United States Attorney (Robert B. Fiske, Jr., United States Attorney for the Southern District of New York, on the brief, William R. Bronner, Assistant United States Attorney, of counsel), *for Defendant-Appellee.*

PER CURIAM:

The taxpayer, Le Beau Tours Inter-America, Inc., seeks to recover $101,698.65 plus interest paid after the Internal Revenue Service disallowed its deductions as a "Western Hemisphere trade corporation" for the taxable years 1966 1967 and 1968. The relevant facts were stipulated before Judge Gagliardi, who granted summary judgment for the United States and dismissed Le Beau's complaint.

Le Beau is in the business of organizing tours to Latin America and the West Indies. It puts together travel plans intended to attract American tourists, and secures the required hotel space and ground services for these arrangements through Latin American representatives. These "package" tours are sold to vacationers by travel agencies in the United States. Le Beau's customers pay Le Beau an amount equivalent to the actual cost of the foreign accommodations and other services. Le Beau then retains a portion of the funds as the "commission" on its sales and forwards the remainder to the actual provider of the foreign services. These commissions comprise Le Beau's income.

The question before us is whether Le Beau qualifies for the special deduction available to "Western Hemisphere trade corporations" under 26 U.S.C. §§ 921-922.[1] Section

[1] 26 U.S.C. § 921 defines a "Western Hemisphere trade corporation" as:

(footnote continued on following page)

921 requires that an eligible corporation must earn at least 95% of its gross income for the three years prior to the close of the taxable year from foreign sources. Le Beau asserts that its compensation is wholly derived from sources outside the United States. We agree with Judge Gagliardi that it is not, and thus, Le Beau does not qualify for a reduction in 1966, 1967, and 1968.

Since Le Beau is a service corporation, the source of its income is determined by the place its compensable services are performed.[2] Le Beau claims it receives its income by making arrangements for hotel accommodations and ground services for, and providing some ground services to, overseas travelers. Thus, it asserts, all its income is from foreign sources. But Le Beau does not provide these services. It merely purchases them from foreign "ground operators" for its American clients. Le Beau's compensation is derived from facilitating and encouraging American travel within the Western Hemisphere. Its services are largely administrative, and consists in the main in planning, organizing and promoting its tours. These services are part of the means whereby Le Beau fosters American travel to Latin America, and are not, as Le Beau contends,

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(footnote continued from preceding page)

> . . . a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:
>
> (1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and
>
> (2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

[2] 26 U.S.C. § 861(a)(3), 26 U.S.C. § 862(a)(3).

mere "expenses" of its business.[3] Judge Gagliardi properly sought to ascertain the proportion of these services performed within the United States. Le Beau, however, stipulated that more than 5% of the time spent in connection with its tours, exclusive of the activities of its foreign ground operators, was attributable to work performed within the United States. Judge Gagliardi properly allocated the source of Le Beau's income on a time basis, as provided by Treas. Reg. 1.861-4(b)(2). *See, Tipton & Kalmbach* v. *United States,* 480 F.2d 1118 (10th Cir. 1973). Thus, we agree with his conclusion that Le Beau derived less than 95% of its income from foreign sources in the relevant years. Accordingly, we affirm.

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[3] Nor are we persuaded by Le Beau's argument that since some of its services are performed in New York by employees of a sister corporation, which is compensated by Le Beau, those services may not be considered in determining the source of its income. Judge Gagliardi correctly rejected this claim.

Opinion of the District Court.

LE BEAU TOURS INTER-AMERICA, INC., Plaintiff,

v.

UNITED STATES OF AMERICA, Defendant.

No. 73 Civ. 1907.

United States District Court, S. D. New York.

March 10, 1976.

Supplemental Opinion May 18, 1976.

Lynton, Klein, Opton & Saslow, New York City, for plaintiff; Frank G. Opton, New York City, of counsel.

Robert J. Fiske, Jr., U. S. Atty., New York City, for defendant; William R. Bronner, Asst. U. S. Atty., New York City, of counsel.

GAGLIARDI, District Judge.

This case raises a question of first impression under Section 921 of the Internal Revenue Code of 1954 (the Code). The parties have stipulated to certain facts and both have cross-moved for summary judgment.

The plaintiff, Le Beau Tours Inter-America, Inc. ("Le Beau Inter-America") sues for a refund of more than $100,000 in taxes it paid for the years 1966 through 1968 pursuant to a deficiency notice from the I.R.S. for those years. The deficiency resulted from the government's disallowance of plaintiff's claim that it qualified under Section 921 of the Code as a Western Hemisphere trade corporation (WHTC) and thus was entitled to certain deductions provided for in section 922 of the Code. The plaintiff contends that the income from its travel business is derived solely from commissions paid by hotel and tour operators in Latin America, and thus it qualifies as a WHTC under section 921. The Government on the other hand claims

that Le Beau Inter-America does not so qualify because (1) less than 95% of its income comes from sources outside the United States, and (2) that it is a sham corporation created solely for the purposes of tax avoidance by its parent company, Le Beau Tours, Inc., which does the same kind of business worldwide. For purposes of this motion, the Government is not pressing the sham corporation claim, which both parties agree raises factual questions inappropriate for summary judgment.

So far as relevant, the following facts were agreed upon by the parties. Le Beau Inter-America is a New York corporation organized in 1966 for the sole purpose of qualifying as a WHTC in order to permit Le Beau Tours, Inc. to obtain a deduction under section 922 on certain portions of its Latin American operations. Le Beau Inter-America arranged Latin American package tours to be offered to American tourists, and then through contacts with local hotels and tour operators or guides arranged to have the necessary hotel accommodations and tourist services provided. The American customer would pay Le Beau Inter-America in the United States the full retail price for these services and Le Beau Inter-America would then remit that amount less a certain percentage—which it denominated as a "commission"—to the local hotel or tour operator who actually provided the service. Le Beau Inter-America personnel or local agents acting on their behalf would inspect the local hotels, and presumably make arrangements with local tour operators. Le Beau Inter-America also maintained facilities in the various countries involved so that American tourists abroad could seek assistance from its representatives. At all times, however, the local hotel and tour service operators were independent contractors not under plaintiff's legal control other than by contract.

Le Beau Inter-America in most instances acted as a wholesale travel agent who marketed its services through retail travel agents in the United States. It maintained its New York office in Le Beau Tours, Inc.'s New York office and its bookkeeping and other clerical work was performed by staff members of Le Beau Tours, Inc. in New York. Le Beau Inter-America paid Le Beau Tours, Inc. an annual lump sum for these services.

Section 921 of the Code defines a WHTC as a domestic corporation all of whose business is done in North, Central or South America or in the West Indies which satisfies the following conditions:

(1) 95 percent or more of its gross income for the three year period immediately preceding the close of the taxable year is derived from sources without the United States; and

(2) 90 percent or more of its gross income from such period or such part thereof is derived from the active conduct of a trade or business. Concededly, Le Beau Inter-America meets the second requirement. It is the first that is here in issue.

Plaintiff contends that all its income is derived from commissions paid to it by hotel and tour operators in Latin America for services rendered there, and therefore the source of more than 95 percent of its income is outside the United States. The Government on the other hand claims that the source of a substantial portion of the plaintiff's income is from within the United States. According to the Government, Le Beau Inter-America's operations must be characterized according to one of two alternative theories—either (1) it is a sales business selling in the United States wholesale hotel and tour space in Latin America or (2) it is a service business providing services which are performed both in the United States and in Latin America.

On either theory, the Government asserts more than 5 percent of the plaintiff's income must be considered derived from sources within the United States.

While this Court does not believe that the plaintiff can properly be considered a wholesale seller of hotel space and tours, it does agree with the Government that the plaintiff is engaged in a service business in which services are performed both in the United States and abroad. Therefore, this Court holds that a determination allocating the amount of income derived from sources within and without the United States must be made.

The plaintiff here under the stipulated facts did considerably more than just buy and sell blocks of hotel and tour space. It undertook personal inspections of local hotels, the operators and their capabilities and also had some role in developing and putting together completed package tours. Furthermore, it maintained representatives in various countries to assist American tourists abroad for whom it had arranged services. This broad range of activities indicates that plaintiff was engaged in a service business—arranging and packaging tour programs for American customers.

The question remains, however, as to the source of the income derived from this service business. The term "sources outside the United States" is nowhere defined in Section 921. The regulations issued by the Treasury Department under Section 921 state that the amount of income from sources within the United States and without the United States is to be determined under the rules provided for in Code Sections 861-864 and the regulations thereunder. Treas.Reg. § 1.921-1(c). Those sections provide that "compensation for labor or personal services performed within the United States" is income from sources within the United States, Code Section 861(a)(3), and that compensation for labor and personal services performed outside

the United States is income from sources outside the United States, Code Section 862(a)(3).[1] Therefore, where services are performed both in the United States and abroad, the income from those services is derived partly from sources within and partly without the United States. *Tipton and Kalmbach, Inc.* v. *United States,* 480 F.2d 1118 (10th Cir. 1973). Treas.Reg. § 1.861-4(b)(2), states that for years prior to 1975:

> ". . . when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or service within the United States bears to the total number of days of performance of the labor or service for which the payment is made."

That regulation was changed by the Treasury Department to provide that for years after 1975, the amount of gross income from services performed partially within and partially without the United States "shall be determined on the basis that most correctly reflects the proper source of in-

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[1] Section 863(b) of the Code provides that gross income from sources partly within and partly without the United States may be apportioned according to processes or formulas of general apportionment prescribed by the Secretary or his delegate. Although the statute states specifically that "gains, profits and income— . . . from transportation or other services rendered partly within and partly without the United States, ..." are to be treated as derived from sources partly within and partly without the United States, Code Section 863(b)(1), no regulation under this section applies directly to services of the type in question here. Presumably, the general rules on the source of income derived from sources enunciated in sections 861 and 862 thus apply. *Commissioner* v. *Piedras Negras Broadcasting Co.,* 127 F.2d 260 (5th Cir. 1942); *Tipton and Kalmbach, Inc.* v. *United States, supra.*

come under the facts or circumstances of the particular case." (Treas.Reg. § 1.861-4(b)(1).

In this case the plaintiff contends that all services are performed in Latin America and all its revenue is derived from the local hotel and tour operators for whom it is in essence an agent paid a commission. This court, however, believes that the nature of the plaintiff's activities should not be characterized so narrowly. By its own admission the plaintiff developed package tours and provided assistance to American tourists while in Latin America at least in part through its own representatives. It also on its own account performed the services of selecting, administering and to some extent supervising Latin American travel arrangements and tours for American tourists. In performing these services, it was far more than an agent for its local Latin American contacts. Rather it was a separate service business deriving income from its own performance of certain important and necessary services to its customers. To the degree that these services were performed by the plaintiff or its agents in Latin America the income derived therefrom was from sources outside the United States. To the degree, however, that the plaintiff carried on any activities in connection with the administration, development or execution of the Latin American tours that give rise to its income in the years in question in the United States, this would be income from United States sources.

Although the court agrees with the plaintiff that as a general rule a taxpayer may divide his business by forming a separate subsidiary organized solely for the purpose of taking advantage of the WHTC provisions, *Commissioner* v. *Pfaudler Inter-American Corp.*, 330 F.2d 471 (2d Cir. 1964); Revenue Ruling 70-238, 1970-71 Cum.Bull. 61, Le Beau Inter-America may not void having income attributable to services performed in the United States for the

sole benefit of its Latin American operations characterized as United States source income by contracting for those services with its parent company, Le Beau Tours, Inc. Here, Le Beau Inter-America had to see that these necessary functions were carried out in order to provide the services to its customers from which it derived its gross income. Whether they were provided by employees paid by it directly or employees of its parent company is immaterial to a determination of the place of the performance of the services for purposes of a source of income allocation.[2]

Thus, all time spent by personnel of Le Beau Inter-America or Le Beau Tours, Inc. in performing services which related to the Latin American tours from which Le Beau Inter-America received its income must be considered in determining whether more than five percent of its income was derived from sources within the United States. This includes time spent promoting and advertising tours which Le Beau Inter-America was operating and administrative and clerical work in connection with the tours.

The Government contends that the plaintiff has conceded that it cannot under these circumstances meet the 95 percent source of income test of Section 921. There is, however, no such concession in the record, and thus an evidentiary hearing on this issue must be held. At that hearing plaintiff will have to show that more than 95 percent of the time spent by persons performing services in connection with Le Beau Inter-America's tours took place

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[2] *Commissioner* v. *Piedras Negras Broadcasting Co., supra,* whatever its validity after *Tipton and Kalmbach* is not in conflict with the decision here. There the services were all found to be rendered in Mexico with only minor insignificant activities being rendered in the United States. Here it appears that a fairly substantial portion of the activities which generated Le Beau Inter-America's income—as distinguished from that of its local hotel and tour operators—took place in the United States.

outside the United States. In computing the amount of services so performed, only those services performed which brought income to Le Beau Inter-America—not its ground operators—must be considered.

Accordingly, both motions for summary judgment are denied.

So ordered.

SUPPLEMENTAL OPINION

Pursuant to a memorandum decision of this court dated March 10, 1976, the parties have now stipulated that more than 5% of the time of the officers of Le Beau Tours Inter-America, Inc., the plaintiff, were spent within the United States. The government therefore renews its motion for summary judgment. The motion is granted.

The plaintiff argues that this court's previous decision is erroneous insofar as it holds that activities which generate plaintiff's income taking place in the United States are to be considered in determining the source of its income for purposes of Section 921 of the Internal Revenue Code. In the previous decision this court found that under the circumstances here all activities of plaintiff's officers in the United States in connection with plaintiff's Latin American tours should be considered in determining whether plaintiff derived more than 5% of its gross income from sources within the United States. This finding was based on the determination that plaintiff was engaged in a separate service business in which the services rendered consisted primarily of the arrangement, packaging and promotion of Latin American tours. Plaintiff has now stipulated that more than 5% of the work done by its officers and employees in the arrangement, packaging and promotion of the tours was done in the United States. As this work, in this court's view, constituted the performance of the services for which plaintiff was compensated,

more than 5% of those services were clearly performed in the United States. Under the accepted rule that the situs of the income producing service is the source of the income from a service business, more than 5% of the plaintiff's income was clearly from sources within the United States. The cases cited by plaintiff in which there was activity in the United States that did not give rise to United States source income all involved the sale of goods with title passing abroad, not the rendition of services, performed partially within the United States.

This court's previous decision was not intended to be a rejection of the principles of law set forth in *Commissioner* v. *Piedras Negras Broadcasting Co.*, 127 F.2d 260 (5th Cir. 1942). The confusion of plaintiff's counsel on this point may result from the inadvertent omission of the word "not" from the first sentence of the second footnote of the earlier decision. That sentence should read *"Commissioner* v. *Piedras Negras Broadcasting Co., supra,* whatever its validity after Tipton and Kalmbach is *not* in conflict with the decision here." The earlier decision is amended to correct this typographical error.

Defendant's motion for summary judgment dismissing the complaint is thus granted.

So ordered.

Statutes Involved.

SEC. 921 I.R.C. (26 U.S.C.A. § 921)

SEC. 921. DEFINITION OF WESTERN HEMISPHERE TRADE CORPORATIONS.

For purposes of this subtitle, the term "Western Hemisphere trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:

(1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and

(2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

For any taxable year beginning prior to January 1, 1954, the determination as to whether any corporation meets the requirements of section 109 of the Internal Revenue Code of 1939 shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning prior to January 1, 1954.

SEC. 922 I.R.C. (26 U.S.C.A. § 922)

SEC. 922. SPECIAL DEDUCTION.

(a) **General Rule.**—In the case of a Western Hemisphere trade corporation there shall be allowed as a deduction in

computing taxable income an amount computed as follows—

(1) First determine the taxable income of such corporation computed without regard to this section.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator of which is 14 percent, and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

No deduction shall be allowed under this section to a corporation for a taxable year for which it is a DISC or in which it owns at any time stock in a DISC or former DISC (as defined in section 992(a)).